To agree or not to agree on regional trade? Hiring the stock market as an advisor

Who benefits from Regional Trade Agreements (RTAs)? Empirical studies have a hard time answering this innocent question decisively. Estimating the impact of a RTA on trade is difficult. RTAs are heterogeneous on a number of dimensions. They are also endogenous; countries tend to create them when trade is already high, growing, or both. While the overall effects of RTAs are disputed, there seems to be growing consensus among economists that RTAs tend to foster trade between members but do not substantially divert trade from non-members.

This empirical evidence suggests that it is likely that RTAs increase welfare. But since it is so difficult to get a convincing estimate of the impact of a RTA on trade, only a handful of papers add the (sometimes questionable) structure needed to go beyond pure trade effects. Those studies that do seek to quantify welfare effects often fail to provide evidence of large positive welfare effects. Trefler (2004) and Romalis (2007) document small and positive or insignificant effects on welfare for two prominent trade agreements between Canada and the United States. On the other hand, Egger and Larch (2011) establish – based on a structural model – more pronounced positive welfare effects for the Europe Agreements.

This column proposes an alternative approach; we consult the stock market for its opinion on RTAs. As it turns out, stock markets have a lot to say about which RTAs are relevant. News of RTAs leads stocks markets to rise for RTAs signed between countries that already export a lot, and for poor countries.

In a recent paper (Moser and Rose, 2011), we “hire” stock markets around the world to give us their views about RTA effects. We do this for a number of reasons. Using daily financial market data allows us to isolate the effects of important news about RTAs without corrupting influences. Stock markets also naturally discount the net benefits from a RTA. Since stock market returns are positively correlated with realized trade creation, this approach seems sensible. It also complements other ways to measure the effects of RTAs. Of course, using stock markets is not a panacea;

cautiousness is especially warranted when stock markets are busy with financial crises. Excluding such data is one of the numerous robustness checks employed in Moser and Rose (2011).

What are the critical turning points during inter-governmental negotiations on regional trade agreements? That is, what are the most critical pieces of RTA news for a stock market? Moser and Rose (2011) argue that two important events stand out: a) when governments officially announce the onset of negotiations; and b) when they announce a general agreement. We gather dates for these news items for over hundred RTAs and 80 countries over the last 20 years. We then calculate the domestic stock market returns around the times of these events (adjusted for international stock market movements). We also link these excess returns to the characteristics of both the involved countries and the features of the RTAs.

Two findings seem clear from stock market reactions. First, countries that already trade a lot with each other show positive stock market returns around RTA news dates. This is consistent with idea that trading partners should be “natural”; otherwise, a RTA might divert trade and reduce welfare. Second, poor countries tend to profit from regional trade agreements. This finding is somehow surprising: some observers fear that small and poor countries lack the necessary negotiating power to handle economically powerful partners. Obviously, the counterfactual trade agreement cannot be observed. But the empirical results suggest that poor countries reap – at least – parts of the free trade cake, when they act on their own.

References:

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